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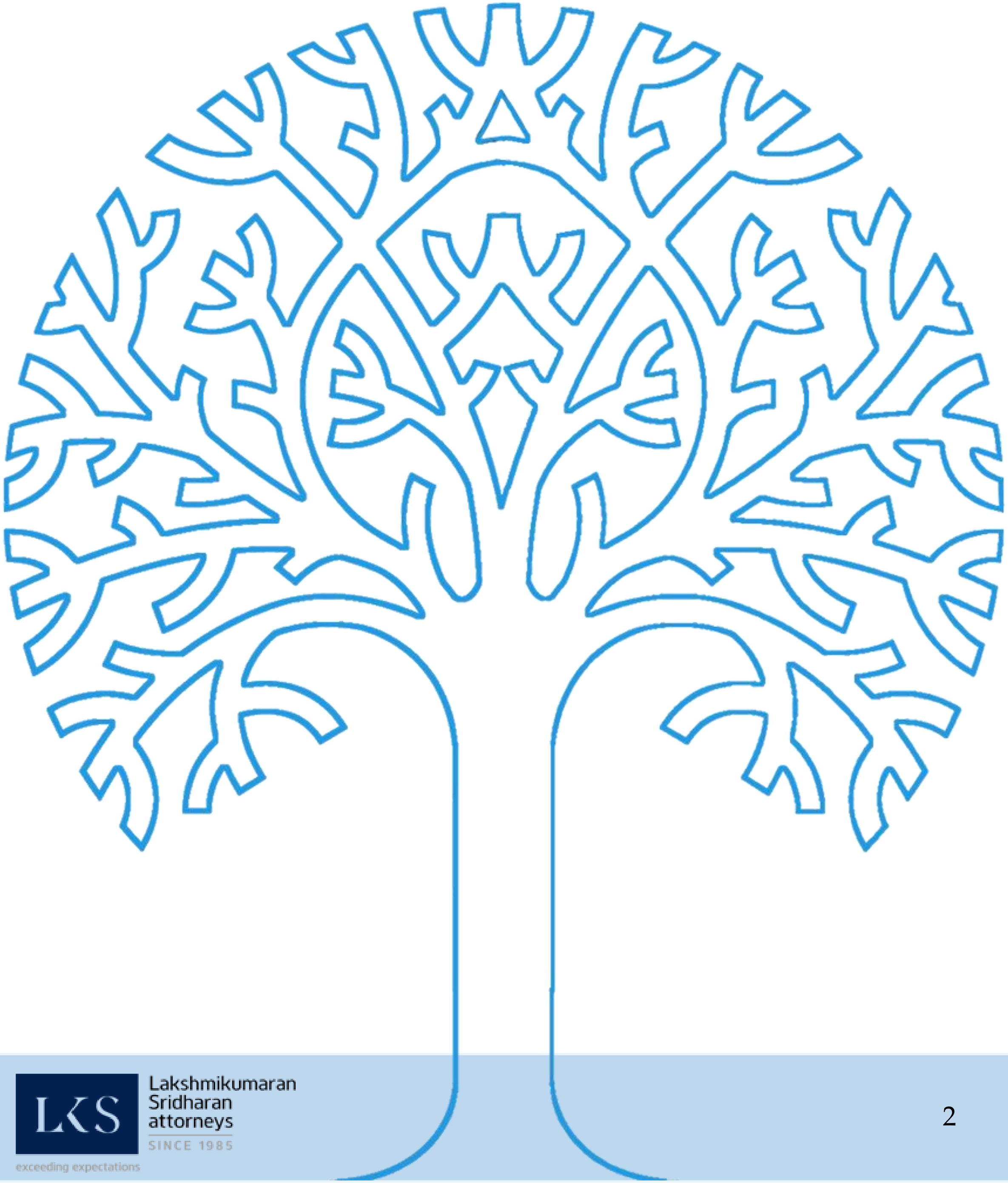

Article

The 'Interest'ing conundrum – Navigating taxation of interest earned from idle project funds

By **Harshit Khurana, Sonali Bansal and Devanshi Khurana**

To secure funds for certain ventures requiring a substantial upfront capital outlay, companies often resort to issuing shares or incurring debt. However, these funds may not always be immediately deployed due to procedural delays in asset acquisition, statutory or contractual obligations, or the phased nature of the project. To maximize returns, companies typically invest these idle funds in interest-bearing securities. The article in this issue of Direct Tax Amicus discusses the issue of taxability of the interest income generated from these securities - whether the interest earned should be taxed as 'income from other sources' or it should be reduced from the value of capital work in progress recognised as 'asset' in the books of accounts. The authors delve into the evolving legal landscape, including the recent decision of the Delhi High Court in International Coal Ventures, and its impact on the taxpayers. According to them, taxpayers planning to undertake similar transactions should evaluate the application of various judicial precedents to their factual matrix and take tax positions prudently.

The 'Interest'ing conundrum – Navigating taxation of interest earned from idle project funds

By Harshit Khurana, Sonali Bansal and Devanshi Khurana

Introduction

Embarking on capital-intensive ventures, such as infrastructure or real estate development, necessitates a substantial upfront capital outlay. This capital is crucial for acquiring assets like land, machinery, and buildings, and for initiating construction activities. To secure these funds, companies often resort to issuing shares or incurring debt. However, these funds may not always be immediately deployed due to procedural delays in asset acquisition, statutory or contractual obligations, or the phased nature of the project. To maximize returns, companies typically invest these idle funds in interest-bearing securities.

The taxability of the interest income generated from these securities has long been a contentious issue within Indian tax law, with numerous cases reaching the Supreme Court. The critical question which has been adjudicated by the Court is whether the interest earned should be taxed as 'income from other sources' ('**IoS**') or it should be reduced from the value of capital work in progress recognised as 'asset' in the books of accounts. While there are multiple judgments of High Courts, the issue is far from being settled.

This article delves into the evolving legal landscape surrounding this complex matter, including the recent landmark ruling in *International Coal Ventures*[1] and its impact on the taxpayers.

Legal landscape

The judicial precedent which is of seminal significance is the judgment of the Supreme Court in the case of *Tuticorin Alkali Chemicals & Fertilizers*[2]. In this case, the assessee had borrowed funds for establishing a factory. It deposited a part of them, which were not immediately required for the factory, as short-term deposits. The Court held that interest income earned on deposited funds should be taxed as IoS. According to the Court, the factors such as non-commencement of business or

[1] ITA 1174/2018.

[2] [1997] 93 Taxman 502 (SC).

borrowing of funds for establishment of the factory would not have an effect on the taxability of the interest income earned by the assessee. If the assessee had chosen to invest the funds fruitfully, instead of keeping surplus funds idle, the interest earned on such funds shall be taxable as IoS.

Subsequently, this question was dwelt by the Supreme Court in judgement of *Bokaro Steel*[3]. In this case, the assessee earned interest from two sources. In the first category, the assessee had earned an interest income on the short-term deposits made from funds borrowed for project. For said advances, the Court followed the ratio laid down in the case of *Tuticorin* and held the interest to be taxable under the head IoS. In the second category, the assessee had extended certain advances to the project contractors for executing large scale construction work smoothly and had earned interest on the same. In this relation, the Court held that the interest income will not be taxable as IoS. The differentiating fact as noted by the Court was that the advances on which the interest income was earned were paid to the contractors to facilitate the work of construction. It was to ensure that the work of the contractors proceeded without any financial hitches. Considering the same, it was observed that the receipts were **inextricably linked** with the construction of its steel plant and should be reduced from the value of capital work in progress.

The principles laid by the Supreme Court in cases of *Tuticorin*, and *Bokaro Steels* were applied in the case of *Karnal Co-operative Sugar Mills Ltd.*[4] In this case, the Supreme Court held that the interest income will not be taxable as IoS since the interest was earned on deposits made in the bank for opening a letter of credit to finalise the purchase of machinery for sugar mill. It was considered as being directly linked with the purchase of plant and machinery.

Further, in the judgment of *Autokast Ltd.*[5], funds were borrowed for purchasing machinery and its running and installation. The assessee earned interest income till the time funds were lying idle. The Court held that the interest is taxable under the head IoS following the judgment *Tuticorin*.

From the above judgments, it is to be noted that while the judgment of *Tuticorin* provided a blanket principle for taxation of interest income, the judgment of *Bokaro* and subsequently the judgment of *Karnal Co-operative* carved out an exception to the general principle. The exception appears to have been carved

[3] [1999] 102 Taxman 94 (SC).

[4] [2001] 118 Taxman 489 (SC).

[5] [2001] 116 Taxman 244 (SC).

out only for those situations where the funds were deposited as a requirement of the project itself, and interest was earned on the same. In such situations, the Apex Court has considered the funds to be inextricably linked to the project, and hence not taxable as IoS.

The above judgments have been applied by the High Courts time and again. Interestingly, in some cases, the High Courts have extended the exception carved out in the case of *Bokaro* to even such cases where the funds were lying idle for commercial reasons such as delay in identifying the property to be purchased. The correctness of the same is yet to be tested before the Apex Court. For instance, in the case of *Indian Oil Panipat*[6], the Delhi High Court held that interest income earned from parking the funds temporarily which were infused for acquiring land, and the development of infrastructure was inextricably linked to the project, and hence not taxable as IoS.

Recent judgment of Delhi High Court in *International Coal Ventures Pvt. Ltd.*[7]

In the facts of this case, the assessee had borrowed funds from promoters for acquisition of coal mine overseas. However, due to certain commercial reasons, the acquisition did not materialise, and the funds were refunded. In the interim, the assessee earned an interest income by depositing the funds as short-term deposits. Upon appeal, the Court held that the interest income earned by the assessee was not chargeable to tax as IoS.

The Court refuted the applicability of *Tuticorin* on the premise that this is not a case of 'surplus' as the funds were borrowed for acquiring the coal mine. The Court relied on the judgments of *Bokaro* and *Indian Oil Panipat* to rule in favour of the assessee by holding that the interest income accrued on borrowed funds, which were temporarily parked as short-term deposits, was *inextricably linked* to the acquisition of overseas coal mines, and hence not taxable as IoS.

The Court also noted that that interest income can only be capitalised in situation where the asset takes a long time to be constructed or takes long time to come into existence, and not for off the shelf assets which immediately comes into existence.

Authors' comments

Considering the legal landscape, one would appreciate that taxation of interest income arising from project funds is a highly fact-centric issue. Even after numerous judgments from

[6] [2009] 181 Taxman 249 (Delhi).

[7] ITA 1174/2018.

the Supreme Court, the application of the judgments to the facts of a given case continues to remain a conundrum. The contradictory judgments of High Courts have further muddled up the situation. It is one such issue where even after a favourable ruling from the High Courts, the taxpayers may not have a sigh of relief. Rather, they would prefer to prepare for the final battleground upfront.

In Author's view, the principle laid down in the case of *Bokaro* has been applied by the High Courts in a wider manner. While the *Bokaro* judgment created exception only for those situations where the funds were invested as an obligation of the project, the High Courts have extended said principle even to cases where the funds were invested for temporary period as per taxpayer's own choice during procedural delays (such as in the recent case of *International Coal Ventures)*. The High Court's while arriving at the conclusion have noted that the funds did not qualify as 'surplus funds' in said cases as they were borrowed for the project and were invested only for a temporary period.

In authors' view, the above interpretation dilutes the principles as laid down by the Supreme Court in the case of *Tuticorin*. In *Tuticorin's* case, the phrase 'surplus funds' was used to indicate funds borrowed for the project which had not been immediately deployed. The fact that said funds were required for the project and were temporarily parked by the taxpayer was not considered relevant by the Supreme Court. Applying *Tuticorin's* principle to the facts such as in case of *International Coal Ventures*, it can be argued that the funds qualified as surplus funds and interest income should be taxed as IoS. It may also be relevant to note that the principle laid down in *Tuticorin* case is *de hors* whether the funds generating the said income were own funds or borrowed funds.

It will be interesting to see whether the Supreme Court approves said position as taken by the High Courts. For the taxpayers planning to undertake similar transactions, it is important to evaluate the application of various judicial precedents to their factual matrix and take tax positions prudently.

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Notifications & Circulars

– Guidelines for setting up income-tax exempted Infrastructure Debt Fund revised
– Timebound filing of Liaison Office’s Annual Statements
– Timelines for furnishing of statement by business and securitization trusts revised
– SEZ – Due date for filing Form 56F extended till 31 March for AY 2024-25

Guidelines for setting up income-tax exempted Infrastructure Debt Fund revised

Income of an infrastructure debt fund set up in accordance with the guidelines prescribed by the Central Government is exempt from tax[8]. Rule 2F of the Income-tax Rules, 1962 ('**IT Rules**') provides guidelines for setting up an infrastructure debt fund, which shall qualify for the said exemption.

The CBDT *vide* Notification No. 13 of 2025, dated 7 February 2025, has partially substituted the said rule. Some of the key changes and their corresponding effects are summarised below:

- **Amendment in sub-rule (1):** Expanding the scope of RBI regulations applicable on infrastructure debt fund by substituting specific references with a general enabling phrase**.** Thereby**,** leeway is being to the RBI to update the relevant regulatory framework.
- **Amendment in sub-rule (2):** Expanding the criteria of projects in which infrastructure debt fund can invest money by removing references to public-private partnership projects, non-public private partnership projects, etc.

  Accordingly, infrastructure debt funds can now invest in any specified infrastructure project which has completed one year of satisfactory commercial operations; or (ii) in toll-operate-transfer projects as a direct lender.
- **Amendment in sub-rules (3) and (4):** Enabling infrastructure debt funds to raise funds in the form of external commercial borrowings in accordance with RBI directions. Thereby, options to raise funds have been expanded.

Timebound filing of Liaison Office's Annual Statements

A non-resident having a liaison office in India is required to furnish an annual statement containing prescribed particulars in Form 49C[9]. The CBDT *vide* Notification No. 14 of 2025 dated 7 February 2025 has now introduced an amendment to Rule 114DA of the Income Tax Rules, 1962 to prescribe that the said form must be submitted within eight months from the end of the

[8] Section 10(47) of the IT Act.

[9] Section 285 of the IT Act read with Rule 114DA of the IT Rules.

financial year. Further, a new form for furnishing the liaison office's annual statement has also been introduced.

Timelines for furnishing of statement by business and securitization trusts revised

Business trust and securitization trust were required to furnish a statement to the Principal Commissioner or Commissioner of Income-tax, in Form 64A and Form 64E, by 30 November of the financial year following the previous year during which income is distributed. The CBDT *vide* Notification No. 17 of 2025 dated 24 February 2025 has notified that the same is now required to be filed on or before 15 June of the financial year succeeding the previous year during which income is distributed.

The notification also updates the formats of Forms 64A, 64B, 64C, 64D, 64E, and 64F.

SEZ – Due date for filing Form 56F extended till 31 March for AY 2024-25

Taxpayers operating in a Special Economic Zone ('**SEZ**') and claiming deductions under Section 10AA of the Income-tax Act, 1961, are required to file Form 56F. Wherein a chartered accountant certifies that the taxpayer has fulfilled the specified conditions for claiming such special deductions under the IT Act. The income tax provisions warrant that Form 56F should be filed one month prior to the due date of furnishing the original return of income[10].

Considering the difficulties faced by taxpayers and other stakeholders in filing the said form in a timely manner, the CBDT *vide* Circular No. 2 of 2025 dated 18 February 2025 has extended the due date for filing Form No. 56F to 31 March 2025 for the Assessment Year 2024-25.

[10] Section 10A(5) read with Clause (ii) of Explanation to S. 44AB of the IT Act.

Ratio Decidendi

- Non-deduction of tax while making freight payment to foreign companies at the time of 'break bulk' – Expenditure disallowable – *ITAT Chennai*
- Commissioner (Appeal) to adjudicate appeal filed against assessment order wherein the underlying issue emanates from intimation order issued by CPC – *ITAT Chandigarh*
- Financial transactions between Holding Co. and Subsidiary Co. would not attract deemed dividend provisions if done out of commercial expediency – *ITAT Kolkata*
- Invocation of Section 56(2)(viib) is unwarranted where the share premium is received by a subsidiary company from its holding company – *ITAT Chennai*

Non-deduction of tax while making freight payment to foreign companies at the time of '*break bulk*' – Expenditure disallowable

In this case, the assessee had made certain freight payments to foreign shipping companies without withholding tax. During the assessment proceeding, the AO observed that since the foreign shipping companies' right to receive payment accrues on completion of services (i.e., delivery of goods in India), the freight income was chargeable to tax under the Income Tax Act, 1961 ('**IT Act**'). Consequently, the AO disallowed the assessee's expenditure claim under Section 40(a)(i) r/w Section 195 of the IT Act. The disallowance was confirmed by CIT(A), leading to an appeal before the Chennai Bench of the ITAT.

The Tribunal upheld the Revenue's contention and dismissed the assessee's appeal by observing as follows:

- That the reliance placed on Instruction No. 1934 dated 14 February 1996[11] by the assessee is misplaced since it does not apply on private shipping companies.
- That the reliance placed on the order of the Mumbai Bench in *Reliance Industries* v. *DCIT*, ITA No. 6177/Bom/1995 by the assessee is misplaced. Since the assessee has admitted that the arrangement was for payment of freight before 'bulk breaking' (i.e., opening hatch of ship for unloading) not under a '*time charter*' agreement.
- That the failure to file Form 15CA and No-PE certificate further strengthens the revenue's argument and its taxability in India.

[*OPG Power Generation Private Limited* v. *Assistant Commissioner* – TS 170 ITAT 2025 (CHNY)]

Commissioner (Appeal) to adjudicate appeal filed against assessment order wherein the underlying issue emanates from intimation order issued by CPC

In this case, the assessee declared deemed income (i.e., book profits) under Section 115JB of the IT Act of INR 1,905 crore, while filing its tax return for AY 2020-21. The same was enhanced to INR 2,106 crore by the Central Processing Center

[11] Instruction titled '*Charter hire for chartering foreign vessels on time charter basis on account of government departments / public sector undertakings*'.

('**CPC**'), and an intimation order was issued under Section 143(1) of the IT Act.

Subsequently, the assessee's case was picked up for scrutiny, and an assessment order under Section 143(3) of the IT Act was passed, duly accepting the disclosures made by the assessee earlier. However, a tax demand of INR 275 Cr. was raised by considering the deemed income as processed by CPC.

Aggrieved by the above, the assessee filed an appeal with the Commissioner (Appeal) against the assessment order issued under Section 143(3) of the IT Act. The said appeal was dismissed by the Commissioner (Appeals) by observing that the underlying issue emanates from the intimation order and not the assessment order. Thus, the same is beyond his jurisdiction while adjudicating an appeal against the assessment order.

Subsequently, the assessee filed an appeal before the Chandigarh Bench of ITAT. In this regard, the Tribunal observed that the intimation order issued u/s. 143(1) gets merged with the assessment order issued u/s. 143(3) once passed. Thus, the Commissioner (Appeals) is bound to consider such an appeal as the assessee continues to be aggrieved by the action of AO and cannot be left remediless. With these observations, the Tribunal directed the Commissioner (Appeals) to admit the grounds of appeal and decide the same by way of a speaking order.

[*SJVN Limited* v. *ACIT* – Order dated 25 October 2024 in ITA No. 150/Chd/2024, ITAT Chandigarh]

Financial transactions between Holding Co. and Subsidiary Co. would not attract deemed dividend provisions if done out of commercial expediency

In this case, the assessee-company had *inter alia* borrowed certain sums from its subsidiary in which it held 74.65% equity. During the assessment, the tax authorities treated these inter-corporate loans as deemed dividends. The same was upheld by the Commissioner (Appeal).

Aggrieved by the same, the assessee-company filed an appeal before the Kolkata Bench of the tax tribunal. The Tribunal, while deleting the income addition on account of deemed dividend, observed that the assessee had been borrowing monies from its subsidiary in the ordinary course of business 'regularly' and 'consistently' out of commercial expediency. Therefore, the income-addition under Section 2(22)(e) of the IT Act was held as not sustainable.

Reliance in this regard was also placed on the Tribunal's earlier order[12] and the previous year's remand report wherein the deemed dividend provisions were held not to be applicable.

[*Merino Industries Ltd.* v. *DCIT* – TS 95 ITAT 2025(Kol)]

Invocation of Section 56(2)(viib) is unwarranted where the share premium is received by a subsidiary company from its holding company

In this case, the assessee had issued Rights shares to its two holding companies (one being non-resident) in equal proportion. During the assessment proceeding, the Assessing Officer ('**AO**') invoked Section 56(2)(viib) of the IT Act and proposed certain income additions, alleging improper application of the Discounted Cash Flow ('**DCF**') method for share valuation. Consequently, the AO applied the Net Asset Value ('**NAV**') method to one part of the transaction. The same was upheld by the Commissioner (Appeals).

Aggrieved by the same, the assessee-company filed an appeal before the Chennai Bench of the tax tribunal. Wherein the assessee contended that it had correctly applied the DCF method in accordance with RBI guidelines. Further, the valuation had been conducted by a registered valuer prior to the transaction, ensuring its legitimacy. The assessee further relied on the Delhi High Court's decision in *FIS Payment Solutions and Services India Pvt Ltd.*[13] to argue that Section 56(2) (viib) should not be applied where no benefit accrues to the assessee or its holding company.

The Tribunal while deleting the income addition, noted that Section 56(2)(viib) is primarily aimed at curbing black money or unaccounted transactions. Thus, the idea to tax unaccounted money and, consequently, its application cannot be extended to tax premiums received by a subsidiary company from its holding company. Further, the Revenue's action of applying two different valuation methods to a single composite transaction was held to be incorrect.

[*Gateway Office Parks Private Limited* v. *ACIT* – Order dated 19 February 2025 in ITA No. 617/Chny/2023, ITAT Chennai]

[12] *Shree Krishna Gyanodya Flour Mills Pvt. Ltd.* v. *PCIT* in ITA No.1008/Kol/2016.

[13] (2024) TS-601-HC-2024(DEL)

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